

Asia rides the crisis

**ECONOMIES
IN TURMOIL II**
Europe's
problems
should not
slow Asia's
financial
liberalization.

Dominique Dwor-Frecaut

SINGAPORE The trillion-dollar bailout put together this month by euro-zone countries has bought them a temporary reprieve, but it has also weakened their credibility. The European dream of dislodging the United States as the supplier of the main world reserve currency now looks unattainable.

Yet Asia — where a number of economies are now stronger than in the United States or Europe — is unlikely, at least for now, to supply the next reserve currency because its economic rise has not been matched by its financial liberalization.

The global financial crisis may have originated in advanced economies, not in emerging markets, but Asia should not be deterred from pursuing financial liberalization.

Until recently, the euro's share of global foreign reserves had been increasing — by 9 percent since its launch in 1999 to 27 percent last year — at the expense of the dollar, whose share had decreased by an equivalent amount to 61 percent last year. These trends are now likely to stop, if not reverse.

The dollar remains the world's main reserve currency, although that is more by default than by choice. The U.S. public debt and deficit, relative to the size of its economy, are the same as Portugal's. The U.S. banking system is not fully recovered from the crisis, and losses on commercial real estate lending are mounting.

But the U.S. dollar has a formidable advantage: If countries stopped investing their foreign reserves in dollars, their currencies would appreciate against the dollar and they would suffer capital losses on their large dollar holdings. These capital losses could be high in countries such as China and Malaysia, which have high foreign reserves.

The United States also has the largest, deepest and most liquid government bond market in the world.

So for all its fundamental weaknesses, the U.S. remains the safe haven of last resort. That is why, even though the global crisis originated in the U.S., the dollar has strengthened whenever global markets have sold off.

In the long run Asian currency appreciation appears unavoidable. Because they have not gone through financial

crises, Asian economies are likely to continue to grow at faster rates than advanced economies. This is bound to be reflected, sooner or later, in currency valuations.

The credit crisis of 2008-09 has given a bad name to open capital inflows. Some think that openness allowed Asia's excess savings to flow to the United States and sow the seeds of financial instability. But poor financial regulation and supervision, together with financial-sector inefficiencies, are more likely to have caused the U.S. crisis than openness to capital inflow.

Hong Kong and Singapore, which are fully open to capital inflow, also have banking systems that are among the strongest in the world.

With a strong financial regulation and supervision, Asia could become more open to capital inflow without experiencing financial instability. China would be better off if its capital inflow took the form of legal investments in its bond markets rather than of unregistered hot money inflows, as is currently the case.

The financial deepening that Asia needs to go through if it wants to supply the next global reserve currency is a long term process.

That is why Asia must not let the European debt crisis get in the way of progress. Asia needs to get on with financial liberalization if it wants one day to see its financial power match its economic might.

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Greater foreign participation could help Asian bond markets reach the size and depth required if Asia is to one day supply a global reserve currency. It would diversify the investor base and increase market size and liquidity. It could also support the adoption of global standards in market practices and regulations.

In addition, more open debt markets could allow quasi-sovereigns and global blue chips to issue debt in Asian markets. This would add to Asia's bond supply that, paradoxically, has been limited by Asia's high public and private savings rates.

The measures that would need to be implemented vary from country to country.

In China and India, where foreign participation in the bond market is very limited, foreigners would need to be given full market access.

South Korea, which has one of the most developed and open bond markets in the region, would benefit from greater participation in global bond indices. It could also benefit from a relaxation of foreign exchange rules that would give foreign investors more flexibility to manage their currency risks.

These changes would increase the capital flowing to Asia and likely lead to currency appreciation. But currency appreciation would help Asia reduce its dependency on external demand when external demand is likely to weaken over the medium term as crisis countries raise their savings to reduce public and private indebtedness.

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